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CREDIT OPINION

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Sutter Health, CA

Update following revision of outlook to stable

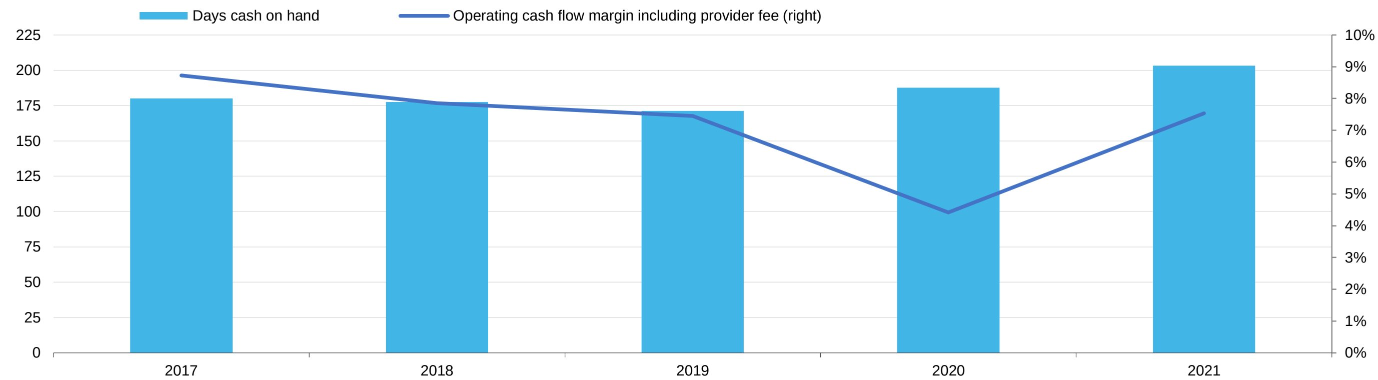
Summary

Sutter Health's (A1 stable) good credit profile reflects our expectation that recent operating improvements will be sustained, and that current balance sheet and leverage measures will not materially weaken from current levels. Following weak operating results in 2020 and through the first quarter of 2021 (which were reflected in our last review), operations improved considerably through the remainder of 2021, resulting in favorable results for the year. Similarly, results through the first quarter of 2022 remained comparatively strong, and despite headwinds relating to a union strike and ongoing labor expense challenges, results for full year 2022 are expected to be on par with 2021 (when normalizing for the provider fee). This is a significant driver of the revision of the outlook to stable from negative. Other ongoing strengths which support the A1 rating include: Sutter's strong presence in northern California; its large size; its favorable market position in each of its markets; its comprehensive array of strong clinical offerings; its conservative asset-liability structure (including a large pension plan that has historically been well funded); and its integrated nature.

Sutter's strengths are moderated by a number of challenges, including: an expensive cost structure driven by high wage rates; a difficult payer environment with only modest increases expected over the next year; and significant competition in most markets. Additionally, Sutter has contracts with various unions equal to about 25% of its workforce which periodically have been a source of operating stress. To that point, the contracts with the California Nurses Association (CNA) are currently open, and CNA staged a one day strike in April which required Sutter to procure replacement staffing. This could be a source of additional operating pressure in the months ahead. Other organizational challenges include: liquidity that remains below the medians for the rating category, despite recent improvement; and debt measures which remain comparably modest.

On May 31, 2022, Moody's affirmed Sutter Health's A1 revenue bond rating, and revised the outlook to stable from negative

Exhibit 1
Balance sheet and operations show improvement, supporting the revision of the outlook to stable



Based on audited financial statements for Sutter Health, for fiscal years ended December 31; California State provider fee included in the calculation of operating cashflow margin and excluded from the calculation of days cash on hand; expenses in 2019 reduced by $644 million relating to a lawsuit settlement and other one-time items; unrestricted cash and investments in 2020 exclude $400 million relating to a draw on a line of credit and $1.2 billion relating to Medicare Advance Payments (MAP) and deferred payroll tax; unrestricted cash and investments in 2021 exclude $801 million relating to MAP and deferred payroll tax
Source: Moody's Investors Service

Credit strengths

- Sutter will continue to benefit from its favorable strategic position, consisting of a large contiguous footprint in Northern California, 29 acute care facilities, a high number of outpatient access points, and over 3,700 aligned physicians
- Operating margins are expected to sustain the gains achieved over the last year
- The healthy condition of Sutter's physical plant will remain a credit positive; having completed a large-scale, 20-year, seismic preparedness project, management intends to maintain capital spending at a rate approximate to depreciation
- Sutter's conservative asset-liability policy will remain a strength, consisting of all fixed rate debt, no swaps, and a historically well-funded pension program
- The California State provider fee program is expected to continue to provide needed and very material ongoing operating support, though the timing of payments will likely remain variable

Credit challenges

- Despite improvements, liquidity is expected to remain below the medians for the rating category
- While no additional debt is currently expected, debt measures will likely remain weaker than many similarly rated peers
- Sutter will continue to face material competition in most major markets from large and financially solid healthcare systems
- Union activity will remain a risk
- Certain markets will likely remain challenging, including San Francisco, and other portions of the Bay Area
- Various headwinds will continue to pressure margins, including the labor shortage, high wage rates, inflation, and ongoing uncertainty related to COVID

Rating outlook

The revision of the outlook to stable from negative reflects our expectation that recent operating improvements will be maintained, and that debt and balance sheet measures will not materially weaken from current levels.

Factors that could lead to an upgrade

- Significantly improved debt and balance sheet measures
- Sustained material improvement of operating measures

Factors that could lead to a downgrade

- Additional dilution of balance sheet and debt measures beyond expectations
- Return to weaker operating margins
- Material additional disruption due to labor action

Key indicators

Exhibit 3
Sutter Health, CA

	2017	2018	2019	2020	2021
Operating Revenue ($'000)	11,623,000	12,120,000	12,725,000	12,737,000	13,711,000
3 Year Operating Revenue CAGR (%)	5.9	4.5	4.0	3.1	4.2
Operating Cash Flow Margin (%)	5.6	6.0	5.8	3.3	6.5
Operating Cash Flow Margin including Provider Fee (%)	8.7	7.9	7.4	4.4	7.5
PM: Medicare (%)	42.0	43.0	44.0	43.0	43.0
PM: Medicaid (%)	19.0	19.0	18.0	19.0	19.0
Days Cash on Hand	180	178	171	188	203
Unrestricted Cash and Investments to Total Debt (%)	142.1	128.2	136.0	143.0	161.7
Total Debt to Cash Flow including Provider Fee (x)	2.8	3.4	3.4	4.8	3.1

Based on audited financial statements for Sutter Health, for fiscal years ended December 31; California State provider fee excluded from calculations unless indicated otherwise; investment returns normalized at 5%; expenses in 2019 reduced by $644 million relating to a lawsuit settlement and other one-time items; unrestricted cash and investments and debt in 2020 exclude $400 million related to a draw on a line of credit; additionally, unrestricted cash and investments exclude Medicare Advance Payments and deferred payroll tax totaling $1.2 billion in 2020 and $801 million in 2021
Source: Moody's Investors Service

Profile

Sutter Health is the not-for-profit parent of affiliates that make up a large health system centered in Northern California. The system includes 29 acute care facilities, a small health plan, a large number of out-patient facilities, and two medical foundation corporations that contract with medical groups that account for the services of over 2600 physicians. In fiscal 2021, Sutter Health had over $14 billion in revenues, and generated nearly 182,000 admissions.

Detailed credit considerations

Market position: large, integrated, geographically focused delivery system; good revenue growth expected to continue

Sutter will continue to benefit from its well-established business strategy, which consists of providing a full spectrum of services within its northern California footprint. Sutter's contiguous footprint enables numerous operating efficiencies, and Sutter has successfully lowered certain costs over the last several years, and has streamlined system-wide operations. Sutter has a favorable clinical reputation, and the vast majority of its 29 hospitals are substantial in size, and provide high acuity services. Additionally, Sutter is well integrated with its physician networks, and it has a substantial clinic presence throughout its footprint. Sutter's retail footprint includes store front walk-in clinics, and 25 of these are currently in operation. Other investments include the development of a number of surgery centers, the expansion of the Sutter Health Plus network (consisting of more than 90,000 members as of FYE 2021), and a new partnership with Stanford Health to establish a large comprehensive cancer center in the east bay, which is currently under construction.

Following a multi-year trend of declining results, which was then exacerbated by the pandemic in 2020, Sutter undertook an aggressive approach towards improving performance, including: a major voluntary reduction in force affecting 800 FTE's; closing a specialty hospital in Menlo Park; closing the NICU at Sutter Delta; and closing labor and delivery at Sutter Solano. Despite this retrenchment, growth was very strong in 2021, with utilization measures improving in every category, and with revenues growing by 14% (excluding the impact of CARES funding). We believe that management's willingness to reevaluate all aspects of its business plan is a credit strength. Management continues to strategically invest within its current footprint, which should result in the continuation of good revenue growth.

Since last review, two major lawsuits have been resolved. The UFCW lawsuit, which the parties agreed to resolve for $575 million in 2019, received final court approval in 2021. this resulted in the payment of the agreed amount, as well as the implementation of certain terms governing Sutter's payer contracting practices that were agreed upon by the parties through a stipulated injunction. These agreed-upon terms will govern certain aspects of Sutter's payer contracting practices during the period of the stipulated injunction. The $575 million was included as an operating expense on Sutter's income statement in 2019, and came off Sutter's balance sheet in 2021. A second lawsuit - Sidebe - proceeded to a jury trial earlier this year, and was decided in Sutter's favor. While appeals may continue, the resolution of these lawsuits, which have been ongoing for nearly ten years, should allow the organization to refocus on its strengths, and move forward strategically.

Other ongoing challenges include material competition in all of Sutter markets, and certain disadvantages in the operating environment. Competitors include Kaiser Permanente, Dignity Health (part of CommonSpirit Health) and various regional systems. Additionally, operating exclusively in California exposes Sutter to certain California-specific challenges, including: very high labor costs; unfunded operating mandates such as required minimum nurse staffing levels; high managed care penetration; high construction costs; seismic retrofit requirements; and low state reimbursement for Medi-Cal. An additional challenge in California is organized labor, which historically has taken a somewhat aggressive stance towards Sutter at different times over the years. To that point, the contracts with the California Nurses Association (CNA) are currently open, and CNA staged a one day strike in April which required Sutter to procure replacement staffing. This could be a source of additional operating pressure in the months ahead.

Operating performance, balance sheet, and capital plans: improved operating and balance sheet measures are expected to be maintained

We expect Sutter to sustain the operating improvements achieved over the last year despite the ongoing presence of significant headwinds. Strong revenue growth and good recovery of utilization, combined with strategic investments and targeted cost cutting strategies, resulted in materially improved performance in 2021, despite significantly reduced CARES funding versus the prior year (Sutter booked $791 million of CARES funds in 2020, versus just $59 million in 2021). Results through the first quarter of 2022 remain favorable, including an additional $88 million of CARES funds, but excluding any provider fee dollars which have been delayed. Significant headwinds will continue through the remainder of the year and possibly beyond, including: possible additional labor action; the possible continued delay of provider fee funds (the most recent program has not yet been approved by CMS); ongoing very high labor costs; continuation of the labor shortage; inflation; and the possible continued disruption from COVID. Nevertheless, management has demonstrated an ability to achieve stable results despite various challenges, and we expect results to 2022 to still show considerable improvement versus 2020. Longer term, operating cashflow margins are expected to be maintained in the high single digits.

LIQUIDITY

We expect days cash on hand to remain at near current levels (excluding Medicare Advance Funds and deferred payroll tax). Unrestricted cash and investments improved for the second consecutive year despite the payment of the UFCW settlement in 2021. Improvements were driven by strong investment returns and the monetization of a number of assets, driving days cash on hand to over 200 days at FYE 2021 (excluding provider fee expenses from calculations). There may be some decline this year due to investment market volatility and the resumption of Sutter's capital plan (albiet at a lower level), yet long term liquidity should remain generally within current ranges. Management has targeted 175 days as a floor on liquidity, and believes it may remain well above this, which in an improvement over the past.

As of FYE 2021, investment allocation consisted of 40% cash and fixed income, 26% equities, and 34% alternatives. 69% of all unrestricted cash and investments can be liquidated within 30 days.

CAPITAL INVESTMENT

Sutter has successfully completed a 20-year master facilities plan entailing the seismic upgrade of many of its most significant medical centers. Capital spending was particularly low in 2020 and 2021, averaging 0.5 times depreciation. Sutter in moving forward with a number of delayed projects in 2022 resulting in increased capital spending, but to levels that are historically still somewhat modest, measuring a little over 1.0 times depreciation.

Debt structure and legal covenants: debt measures remain modest for the rating category

A historic challenge for the organization bas been its relatively high debt load. Debt measures have improved over the last couple of years, but remain below the medians for the rating category. We expect debt measures to not weaken below current levels.

DEBT STRUCTURE

Sutter's debt structure is favorably conservative consisting of all fixed rate debt, and no swaps. The organization has taken on more market access risk in recent years with the issuance of a number of taxable bullet maturities, with $300 million coming due in 2025, $350 million coming due in 2028, and $700 million coming due in 2030 (among other longer dated bullets). Nevertheless, we believe the absence of material exposure to interest rate volatility, put risk, bank renewal risk, or swap mark-to-market risk, are important mitigants to Sutter's somewhat high leverage.

LEGAL SECURITY

A new MTI was implemented concurrent with the 2020 bond transaction. Under the new MTI, bonds are secured by a gross receivables pledge. All members of the Obligated Group are jointly and severally liable with respect to the payment of each obligation secured under the MTI. Financial covenants of the MTI and Sutter's credit facility include a debt service coverage requirement of over 1.1 times, and a days cash on hand requirement of over 70 days. In 2021, Sutter posted sufficient headroom on all of its covenants.

DEBT-RELATED DERIVATIVES

None

PENSIONS AND OPEB

Sutter has historically had the practice of keeping its defined-benefit pension program well funded. At FYE 2021, the program had a funded ratio of 98%. Other indirect debt includes operating lease liabilities, which is also relatively low at $479 million. Overall, Sutter's low amount of indirect debt is an important mitigant to its high level of direct debt.

ESG considerations

Environmental

Sutter's largest exposure to environmental risk is wild fires, which have occurred in various of Sutter's service areas in recent years, and have affected operations. Mitigants to this include Sutter's geographic diversification within its foot print, a certain level of balance sheet strength, and other resources that come from the organization's size, structure, and importance.

Social

Social considerations include the high cost of living in Northern California, high cost of construction, a challenging payer mix, high managed care penetration, and various unfunded mandates from the state. Additionally, Sutter operates in a politicized environment which has resulted in a high level of legal activity, and Sutter's exposure to unions is high, which recently resulted in a strike. Favorably, the system benefits from California's provider fee program which is correlated to Sutter's exposure to Medicaid, and which provides significant additional support. An additional social consideration is the ongoing impact of COVID, which remains an area of uncertainty, and which could result in further operating pressure.

Governance

Sutter's current CFO joined in 2020, and came from outside the organization. Sutter's most recent CEO left in early January of this year, and a search for a permanent replacement is nearing conclusion. The former COO is currently serving as interim CEO, and there is an interim COO. The remainder of the senior management team has been stable. Additionally, Sutter benefits from a deep bench. Disclosure practices are standard.

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